5/15/81

Financial Markets

Irving Trust

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Economic Research & Planning Division

Friday
(Noon)

May 15, 1981

Trading in financial markets this week was quite thin, though the generally lower than expected Federal funds rate helped some rates to post small declines. Underlying the market's nervousness was a widespread expectation that the Federal Reserve's Friday night data release would show a large increase in the M-1B aggregate for the week ended May 6, reflecting a technical distortion created by the early payment of Social Security checks in that week.

It's certainly not news that the funds rate behaves strangely at times and that the Federal Reserve these days is willing to tolerate wide variations in the level of the rate. However, it is not generally appreciated that the Fed's discount rate structure also contributes to distortions in the rate and its relationship to the amount of discount-window borrowing. The 4% surcharge over the basic 14% discount rate applies only to banks with more than $500 million in deposits and is effective only after they have borrowed during two consecutive weeks or four times during the calendar quarter. This structure makes the relationship between pressure on the funds rate and borrowing very difficult to interpret, since the "opportunity cost" for a bank seeking funds to cover a reserves shortage can range from 14% to 18%, depending on its peculiar individual circumstances.

The main reason for the Fed's introduction of the surcharge was to curb abuse of the borrowing privilege by banks, particularly in terms of the frequency of borrowing, a penalty that was needed in view of the reputed difference in the administration of the discount window in some Federal Reserve districts.

At the same time, however, the very low basic discount rate embodies the view that banks should not be forced to pay a penalty for "uncontrollable" shocks to their reserve positions. The problem with that arrangement is that it subsidizes banks that refrain from making the investments needed to manage positions more carefully.

Currently, two initiatives could be taken to improve the relationship between the funds rate and borrowing pressure. One is to restrict the surcharge to, say, 1% and to make both the basic rate and the surcharge applicable to all classes of banks. The second is to define the penalty in terms of the dollar amount a bank borrows during the most recent 13 weeks, not merely the number of times the bank borrows. The logical way to set the amount would be to make it a small fraction of a bank's required reserves for the previous three months. That would provide for most legitimate adjustment needs, while preserving the incentive for banks to manage their positions efficiently.

As it is, a good part of the recent softness in the funds rate appears to be due to substantial numbers of banks continuing to borrow at the 14% basic rate. As the quarter wears on, however, more and more banks will become subject to the full 18% rate, thus--everything else being equal--imparting more firmness to the funds rate.

William C. Melton

Note: The full text of the letter is available to Telerate subscribers on pages 7250-51 on the Monday morning following the Friday date of the letter.

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Market Yields

	5/15/81 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	19.50%	19.00%	16.50%
Effective since	5/11/81		
Discount Rate at Federal Reserve Bank	14.00	14.00	13.00
Federal Funds	18.50	18.00	11.63
Repurchase Agreements	17.00	17.50	10.25
U.S. Treasury Issues			
Bills			
3 months	17.35	17.38	9.30
6 months	16.90	17.01	9.42
1 year	16.60	16.39	9.58
Coupons			
2 years	15.61	15.63	9.64
4 years	15.25	15.09	9.84
7 years	14.40	14.42	10.20
10 years	14.10	14.20	10.30
Long Bond	13.60	13.75	10.47
Negotiable Certificates of Deposit-Secondary Market			
1 month	18.80	18.80	10.25
3 months	18.80	18.85	10.25
6 months	18.10	18.20	10.10
1 year	17.30	17.20	10.20
Banker's Acceptances			
1 month	18.75	18.40	9.80
3 months	18.75	18.75	9.95
6 months	18.15	18.15	10.10
Eurodollar Deposits			
1 month	19.00	19.25	10.38
2 months	19.50	19.38	10.69
3 months	19.63	19.50	11.13
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	18.00	18.00	9.25
1 month	17.75	17.50	9.00
3 months	17.00	16.75	8.88
Bank Holding Companies			
1 month	18.50	18.50	9.50
Dealer Placed:			
3 months	18.05	18.00	9.50
New AA Corporate Utility Bond	15.75	16.35	11.85
Tax Exempt			
6 month Project Notes	7.80	7.65	5.50
1 year AAA Bond	7.50	7.80	5.40
5 year AAA Bond	8.35	8.50	5.70
20 year AAA Bond	10.10	10.00	6.90

This information represents prevailing market yields.

It should not be construed as an offering.

All yields are on the offered side of the market.

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